No. 80-

In the

Supreme Court of the United States.

OCTOBER TERM, 1980.

ROBERT W. MESERVE AND BENJAMIN H. LACY,
REORGANIZATION TRUSTEES OF THE BOSTON AND MAINE
CORPORATION, DEBTOR, AND
THE FIRST NATIONAL BANK OF BOSTON AND
MALCOLM W. HALL,
SUCCESSOR INDENTURE TRUSTEES,
PETITIONERS,

v.

CHESAPEAKE AND OHIO RAILWAY COMPANY,
MAINE CENTRAL RAILROAD COMPANY,
PENN CENTRAL CORPORATION, CANADIAN PACIFIC,
AND EASTERN ASSOCIATED COAL CORP., ET AL.,
RESPONDENTS.

Brief of Eastern Associated Coal Corp. in Opposition to Petition for a Writ of Certiorari.

PHILIP BURLING,
THEODORE P. SETO,
FOLEY, HOAG & ELIOT,
10 Post Office Square,
Boston, Massachusetts 02109.
(617) 482-1390

BATEMAN & SLADE, INC. BOSTON, MASSACHUSETTS

Questions Presented for Review.

1. Did the Court of Appeals err in determining that there exist two distinct principles under which a supplier of essential diesel fuel to a railroad in the six months immediately preceding bankruptcy may be entitled to a priority under the Six Months Rule, one relying upon mortgage law and the principles of equitable restitution and the other arising out of the public nature of railroad corporations and the need to keep them operating? More particularly, did the Court of Appeals err in reversing and remanding for a determination as to whether respondent's claim for diesel fuel delivered to the railroad fell under either principle, and was therefore entitled to priority either as an ordinary pre-receivership operating expense or as a payment in the nature of an administrative expense under that Rule?

2. Did the Court of Appeals err in determining that it was inappropriate to reduce operating revenues by an amount representing depreciation in order to determine whether a fund existed out of which Six-Months claims governed by equitable restitution and principles of mortgage law could be paid?

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RESPONDENTS.

Brief of Eastern Associated Coal Corp. in Opposition to Petition for a Writ of Certiorari.

Parties to this Proceeding.

Petitioners are identified in the Petition. Respondents are the Chesapeake and Ohio Railway Company, Baltimore and Ohio Railway Company, Western Maryland Railway, Maine Central Railroad Company, Portland Terminal Company, Penn Central Corporation, Canadian Pacific and Eastern Associated Coal Corp.

This brief is submitted on behalf of respondent Eastern Associated Coal Corp. ("Eastern"),[1] which was a claimant in the reorganizational proceedings for a sum amounting to $225,615.24 for railroad diesel fuel delivered to the debtor railroad Boston & Maine Corporation ("B & M") and used by the railroad within six months prior to the filing of the Section 77 Petition.

Opinion Below.

The opinion of the Court of Appeals is reproduced in the Petition Appendix A. at pp. A-1 to A-47.[2]

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[1] Eastern is a wholly-owned subsidiary of Coal Properties Corp. (the "Parent"), which in turn is a wholly-owned subsidiary of Eastern Gas and Fuel Associates (the "Grandparent"), a publicly held company whose stock is listed and traded on the New York Stock Exchange. The Parent and the Grandparent each have a substantial number of wholly-owned subsidiaries. Eastern does not understand Rule 28.1 to require a listing of all such wholly-owned subsidiaries. If, however, the Court desires such a listing, Eastern would be happy to provide one.

Eastern is not directly affiliated with any other company. Eastern's indirect affiliations with companies which are or may be publicly held are as follows. The Grandparent holds approximately 36.8% of the common stock of Algonquin Energy, Inc. The remaining shares of Algonquin Energy, Inc. are held by New England Gas & Electric Association, Texas Eastern Transmission Corp. and Providence Gas Company, which companies are otherwise unaffiliated with Eastern. Several of the Grandparent's wholly-owned subsidiaries are engaged in joint ventures with NICOR Inc., which company is otherwise unaffiliated with Eastern.

[2] The Petition will be cited herein as "Pet. ," and the various Appendices thereto will be cited as "App. ."

Statement of the Case.

This Petition stems from an order of the District Court dated March 19, 1979, in the course of proceedings for the reorganization of the B & M pursuant to § 77 of the Bankruptcy Act, 11 U.S.C. § 205 (App. B-23 to B-24). In that order, the District Court established a division of creditors and denied requests for a separate class, with appropriate priority, for claims asserted under the Six Months Rule and other equitable doctrines.

The proceedings in the District Court commenced when an involuntary petition for reorganization under § 77 of the Bankruptcy Act, 11 U.S.C. § 205, was filed against the B & M on March 12, 1970. In September, 1970, Eastern duly filed a proof of claim in the reorganization proceedings for the amounts owed by the B & M to Eastern for railroad diesel fuel delivered to the B & M and used by the railroad for its day-to-day operations within six months prior to the filing of the Section 77 petition. Eastern asserted that it was entitled to priority under the Six Months Rule, the necessity-of-payment rule, and other applicable principles of equity.

In November, 1977, the Reorganization Trustees filed a petition of Trustees to classify creditors and stockholders. This petition was part of a plan under which, after reservation of funds sufficient to cover prior claims, the Trustees would utilize funds available to them to make a tender offer on the railroad's first mortgage bonds.

Following a hearing on November 13, 1978, the District Court issued a memorandum opinion and adopted the classification of creditors proposed by the Trustees (App. B-5 to B-19). The District Court held that Six-Months creditors were not entitled to a separate priority classification. As a result, the District Court included Eastern's claims in the priority category for holders of general unsecured claims (App. B-24).

The District Court did not define the scope of any Six-Months class; nor did it undertake to determine whether Eastern or any other respondents had stated claims falling within the class. Rather, its holding was solely that no such separate Six-Months class should exist (App. B-19).

The Court of Appeals for the First Circuit, in an opinion by the late Judge Dooling, sitting by designation, reversed the order of the District Court insofar as it failed to provide a separate class for creditors claiming under the Six Months Rule (App. A-46). In its decision, the Court exhaustively reviewed the prior case law, both in this Court and in other federal courts, and enunciated a careful and scholarly statement of the policies and principles which govern this somewhat arcane corner of railroad reorganization law, concluding that those policies and principles, as applied to this case, required the creation of a separate class for creditors claiming under the Six Months Rule. The Court remanded for further proceedings, which its decision indicates should include a determination of the membership of such a class. Petitioners now seek review of the First Circuit's decision by writ of certiorari. Eastern files this brief in opposition.

Reasons for Denying Certiorari.

Petitioners contend that the policies and principles which underlie the Six Months Rule have been subjected to conflicting determinations by the various circuits of the Court of Appeals. They contend further that the decision below stands in conflict with the prior decisions of this Court and with the intent of Congress.

Closer scrutiny reveals, however, that petitioners' contentions are without merit. Eastern associates itself with the

views set forth in briefs filed by respondents Maine Central Railroad Company, Portland Terminal Company, Chesapeake and Ohio Railway Co., Baltimore and Ohio Railway Co., and Western Maryland Railway with respect to the extent of any conflict with the decisions of other circuits or with the intent of Congress in enacting the Bankruptcy Reform Act of 1978, and will not discuss those questions here at any length. Eastern will focus instead on petitioners' contention that the decision below ignored the prior decisions of this Court. It is Eastern's position: (1) that the Court below properly construed the policies and principles which underlie the Six Months Rule and properly applied that Rule to this case; and (2) that the Court below properly held that depreciation should not be deducted in determining the existence of a fund available for Six-Months claimants. For these reasons, the Petition should be denied.

I. The First Circuit's Decision was a Scholarly and Historically Accurate Interpretation of the Opinions of this Court and Correctly Applied the Six Months Rule to the Facts of this Case.

After an exhaustive review of the case law, both in this Court and in other federal courts, the Court below concluded that the Six Months Rule embodies "two essentially different principles, neither of which limits the operation of the other, and both of which may operate in the same reorganization to embrace many of the same claims" (App. A-35).

The first element of the Rule, the Court observed, derived from this Court's decision in *Fosdick* v. *Schall*, 99 U.S. 235 (1878). Examining that decision in detail, the Court below concluded:

> "*Fosdick's* principle, then, is one of mortgage law: that the mortgagee's interest attaches to *net* income, which arises only after the payment from gross earnings for all necessary operating and managing expenses, proper equipment, and useful improvements, and that, in consequence, to the extent that before or during receivership bonded interest has been paid, additional equipment provided, or lasting and valuable improvements in the mortgaged property have been made out of earnings which ought in equity to have been used to pay debts for labor, supplies and the like, the receivership court can use receivership income or, in some cases, the proceeds of sale of the mortgaged property, to pay the debts that, but for the diversion of funds, would have been paid in the ordinary course of business."

(App. A-18; emphasis in original.)

The Court below found a second and distinct principle recognized by this Court in *Miltenberger* v. *Logansport Railway Co.*, 106 U.S. 286 (1882), which it correctly characterized as follows:

> "*Miltenberger* is concerned, not with the 'diversion' precept of *Fosdick*, but with the more general authority of the receivership court to accord priority status to prereceivership claims in order to prevent the stoppage of a business impressed with the public interest. The case emphasizes the power of the court to effect payment of prereceivership claims and the validity of the means it chooses to effect payment; the analysis is not in terms of the property interest of operating expense creditors in operating revenues and the limitation of the mortgagee's rights to net income, but it is in terms of paying those

> pre-receivership expenses that are brought within the principle of administrative expenses by their relation to the continuance of the railroad business."

(App. A-21.) Specifically, the Court below noted this Court's conclusion in *Miltenberger* that payment of pre-receivership debts:

> where a stoppage of the continuance of such business relations would be a probable result, in case of non-payment, the general consequence involving largely, also, the interests and accommodation of travel and traffic, may well place such payments in the category of payments to preserve the mortgaged property in a large sense, by maintaining the good-will and integrity of the enterprise, and entitle them to be made a first lien.

Miltenberger, *supra*, 106 U.S. at 312 (App. A-36).

The Court then examined with great care petitioners' apparent contention that this Court's decision in *Miltenberger* was "a Necessity of Payment holding in the starkest economic duress form" (App. A-37), correctly concluding:

> "The Court's rationale excludes the inference that only those creditors are entitled to priority of payment who demand immediate payment as a condition of continuing to supply a service or commodity of which they are monopolists. The Court was defining the *classes* of claims payment of which was indispensable to the business of the road and which 'unless the receiver was authorized to provide for them at once, the business of the road would suffer great detriment.' The Court's depiction of the dis-

> astrous consequences of failing to pay labor claims — a work stoppage — or interline claims — a stoppage of traffic interchange — is directed to restricting the class of claims entitled to priority of payment to claims for those goods and services that are indispensable to the continued performance of the transportation service. The point is to single out the pre-receivership expenses the payment of which although it — *prima facie* — may stand on a different principle from that governing payment of administrative expenses, 'may be brought within the principle of the later by special circumstances.' The test is not whether the claimant has the naked power to exert economic duress, but whether the expenses have the characteristics of those that the receiver pays from revenue as expenses of administration or pays out of the proceeds of the sale of first lien receiver's certificates."

(App. A-36 to A-37; citations and footnotes omitted; emphasis in original.)

Having concluded that the existence of a "current debt fund" was not germane to the propriety of separate priority treatment for Six-Months claims under *Miltenberger*, the Court therefore reversed the order of the District Court "in so far as it failed to provide a separate class of creditors" under the Six Months Rule (App. A-46). Remanding for further proceedings, the Court stated:

> "when the time comes to determine the membership in the class it will be for the reorganization court to determine what claims belong in the class because they represent indebtedness for ordinary and necessary current operating expenses indispensable to continued rail service of the kinds being paid currently as expenses of adminis-

> tration; whether the non-payment reflects an intentional extension of credit to the railroad, or the intervention of the reorganization petition before the expiration of the ordinary billing and payment period, or some non-contractual indulgence or inadvertence on the part of the claimant, or deferment of payment on the part of the railroad; and whether, if the transaction giving rise to the claim had any credit term, it was compatible with a general expectation of payment from current receipts or indicated reliance on the railroad's general credit."

(App. A-40 to A-41.)

Petitioners attack "[t]he Court of Appeal's utilization of *Miltenberger* as an alternate basis for operation of the Six Months Rule," contending instead that the *Miltenberger* principle should be labelled the "Necessity of Payment Rule" (Pet. 25). Apparently, petitioners would have this Court uphold the District Court's view that *Miltenberger* merely held that "the court may permit the trustee to pay the claim though it was not entitled to special priority" and its further holding that the *Miltenberger* principle "is not a rule of priority; it is a rule of payment" (App. B-19 to B-20).

Petitioners' contentions, however, fly directly in the face of the language of *Miltenberger* itself, where this Court introduced its holding with the following statement:

> Many circumstances may exist which may make it necessary and indispensable to the business of the road and the preservation of the property, for the receiver to pay pre-existing debts of certain classes, out of the earnings of the receivership, or even the *corpus* of the property, under the order of the court, *with a priority of lien.*

106 U.S. at 311 (emphasis added). This Court then gave examples of circumstances which:

> may well place such payments in the category of payments to preserve the mortgaged property in a large sense, by maintaining the good-will and integrity of the enterprise, and *entitle them to be made a first lien.*

106 U.S. at 312 (emphasis added). Similarly, in *Virginia & Alabama Coal Co.* v. *Central Railroad & Banking Co.*, 170 U.S. 355, 366 (1898), this Court described the *Miltenberger* holding in the following language:

> Claims thus arising were afterwards allowed to be paid out of the proceeds of sale before the mortgage bonds. This court upheld such *priority* . . .. (Emphasis added.)

A virtually identical characterization appears in this Court's opinion in *Union Trust Co.* v. *Illinois Midland Co.*, 117 U.S. 434, 457 (1886). It therefore appears that the District Court was flatly wrong and that, whatever label may be attached to the principle set forth in *Miltenberger*, that principle is, as the Court below properly held, a rule of priority.

Petitioners claim that the Court below ignored this Court's opinion in *Gregg* v. *Metropolitan Trust Co.*, 197 U.S. 183 (1905). Specifically, petitioners claim that the Court below ignored the following statement about *Miltenberger* made in the *Gregg* decision:

> The ground of such allowance as was made was not merely that the supplies were necessary for the preservation of

> the road, but that the payment was necessary to the business of the road — a very different proposition.

Gregg, supra, 197 U.S. at 187 (Pet. 24-25). Petitioners would apparently have this Court uphold the decision of the District Court, which implicitly relied on the fact that none of the respondents "has insisted on payment of its claim as a condition of its providing goods and services to the Debtor" (App. B-19).

Petitioners' assertions are unfounded. Having reviewed *Miltenberger, Gregg,* and every case involving the Six Months Rule decided by this Court between *Miltenberger* and *Gregg,* the Court below correctly concluded that in *Miltenberger,* this Court

> was defining the classes of claims *payment of which was indispensable to the business of the road* and which, "unless the receiver was authorized to provide for them at once, the business of the road would suffer great detriment."

(Emphasis added) (App. A-36) quoting *Miltenberger, supra,* 106 U.S. at 311. The Court below was thus clearly cognizant of the premises of the *Miltenberger* decision.[3]

The question, the Court below reasoned, was how to determine which claims would fall within the enunciated principle. Again, the Court below turned to the *Miltenberger* decision for guidance. The Court noted that this Court's rationale precluded any conclusion that a creditor would have to threaten to discontinue supply in order to be entitled to a "first lien"

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[3] Petitioners themselves appear to ignore the rationale of the *Gregg* decision. *Gregg* held simply that "special circumstances" did not exist in the facts of the case presented.

under the *Miltenberger* principle. (Indeed, it is hard to see how what is effectively blackmail could constitute the basis for an equitable priority.) Therefore, the Court below reasoned, it was necessary to look at *classes* of claims, "payment of which was indispensable to the business of the road." This Court had, in *Miltenberger*, given examples of the types of claims that might qualify. The Court below reasoned that these examples were intended to restrict

> the class of claims entitled to priority of payment to claims for those goods and services that are indispensable to the continued performance of the transportation service.

(App. A-36 to A-37.) The analysis of the Court below was thus fully consistent with both *Miltenberger* and *Gregg*.

Indeed, this Court has long recognized that special considerations attach to continuing business relationships which span the appointment of a railroad receiver. The *Miltenberger* opinion itself emphasized the importance of preserving "indispensable business relations." 106 U.S. at 312. In *Southern Railway* v. *Carnegie Steel Co.*, 176 U.S. 257, 288-290 (1900), the Court specifically addressed the problem of a continuing relationship between the railroad and its indispensable supplier. Noting that rail purchases after appointment of the receiver were "payable out of current receipts in preference to the claims of mortgage creditors" (*id.* at 288), this Court, by Mr. Justice Harlan, then reasoned:

> Why should a different rule be applied to the contracts made with the [Debtor] shortly before the appointment of receivers . . .? Is it to be said that the contract for 2000 tons of steel rails and the contract for 2500 tons made by

> the receivers in the foreclosure suit, created debts of a preferential character, while contracts made by the railroad company of exactly the same kind shortly before the appointment of receivers for 2500 and 1656 tons of steel rails could not under any circumstances become a preferential debt chargeable upon current receipts? (Original emphasis deleted.)

Id. at 289. This Court concluded that there was no good reason for treating the two essentially similar claims dissimilarly.

In sum, contrary to petitioners' contentions, the decision below was fully consistent with this Court's prior cases. The careful language and exhaustive study evident in the First Circuit's opinion represent a wholly adequate statement of the principles which support the Six Months Rule, and constitute a workable document for practitioners in the area who must interpret the Rule in future railroad bankruptcies. Admitting that this is an arcane area of law with infrequent applicability in the great body of Federal law, it seems entirely appropriate to allow the matter to stand as it was left by the First Circuit in the opinion below.

II. The First Circuit Appropriately Excluded Depreciation from the Calculation of a Fund Available for Six-Months Claimants.

The court below held that, in determining the existence of a "current debt fund" to which priority may attach for payment of pre-reorganization operating expenses under the equitable restitution principle enunciated by this Court in *Fosdick* v. *Schall*, 99 U.S. 235 (1878), depreciation should not be deducted

from gross operating revenues in computing the income component[4] of that fund. Petitioners seek a ruling from this Court that depreciation should be so deducted. It is not clear whether petitioners contend that the treatment of depreciation below was inconsistent with prior decisions of this Court. It is, however, clear that depreciation has not been deducted in any case heretofore decided by this Court in applying the *Fosdick* principle and that, to the extent this Court has spoken to the question, it has affirmed the First Circuit's approach.

The reason petitioners cite no cases of this Court holding that depreciation should be deducted in calculating the income component of the current debt fund is evident: there are none. Indeed, so far as can be determined from the opinions

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[4] The funds from which preferential claims may be paid under the principle of *Fosdick* have been catalogued as follows:

> "(1) Pre-receivership gross operating income taken over or collected by the receiver, less taxes accrued during the pre-receivership six-months period; (2) receivership net operating income; (3) unpledged assets belonging to the company; (4) funds from some source, even from the corpus of the mortgaged property if necessary, sufficient in amount to restore gross operating income of the company which was diverted during the pre-receivership six-months period from the payment of current ordinary operating expenses of said six-months period to the payment of accruing interest on mortgage indebtedness of the company or to capital account expenditure; (5) funds from some source, even from the corpus of the mortgaged property if necessary, sufficient in amount to restore or produce net operating income of the receivership period which shall hereafter be found to have been diverted from the payment of ordinary operating expenses incurred during the pre-receivership six-months period to the payment of accruing interest on mortgage indebtedness of the company or to capital account expenditure; (6) a possible surplus remaining above mortgage indebtedness of the company after a sale of the mortgaged property."

Guaranty Trust Co. v. *Albia Coal Co.*, 36 F.2d 34, 36 (8th Cir. 1929). This aspect of the First Circuit's opinion addresses only the second element, that of "net operating income."

of this Court, the existence of available income has always been determined on a cash-flow basis, without any deduction for depreciation.

The very statement of the rule in *Fosdick* demonstrates the cash-flow basis of the computation which must be undertaken:

> Every railroad mortgagee in accepting his security impliedly agrees that the *current debts* made in the ordinary course of business shall be paid from the *current* receipts before he has any claim upon the income. (Emphasis added.)

99 U.S. at 252. The Court did not say that pre-reorganization supplies of items necessary for the operation of the road could only be paid from gross operating revenues less depreciation (or even from net operating revenues less depreciation). Rather, as it later articulated in *Virginia & Alabama Coal Co.* v. *Central Railroad & Banking Co., supra,* 170 U.S. at 365:

> the indebtedness, as between the party furnishing the materials and supplies and the holders of bonds secured by a mortgage upon the property is a *charge in equity on the continuing income* . . .. (Emphasis added.)

Mr. Justice Harlan's computations in *Southern Railway, supra,* 176 U.S. at 293-294, clearly demonstrate this Court's consistent position. Nowhere in that decision did this Court permit a deduction for depreciation of property covered by the mortgage. With respect to one line of the railroad, the Court examined in some detail "the cash statement of the receipts and disbursements." *Id.* at 294. Among the disbursements, the Court found one for "Car Trust payments and Sinking

Fund." Under a cash-flow method of accounting, the sinking fund is commonly used in place of depreciation: amounts approximating the wear and tear on equipment are deposited into the fund so that the net worth of the company will not be overstated, and so that when time comes to replace worn-out equipment, there will be funds available for such replacement. The Court characterized amounts disbursed to this sinking fund as being "for the benefit of mortgage creditors," stating that they "should have been applied in payment of preferential claims" instead. *Id.* at 295. In short, this Court found that the functional equivalent of depreciation under the accounting system in use at the time constituted a diversion for the benefit of the mortgagees.

Thus, the First Circuit's conclusion that the deduction of depreciation charges was improper in calculating the income portion of the current debt fund was fully consistent with the prior cases of this Court.

Conclusion.

The opinion below represents a thorough and careful discussion of the history and interpretation of the Six Months Rule as it applies to railroad bankruptcy reorganization. It is fully consistent with the prior cases of this Court and offers a definitive resolution of questions improperly resolved by the reorganization court. For these reasons, and because the case

involves a doctrine of extremely limited applicability, it is submitted that the Court may properly deny a petition for a writ of certiorari.

Respectfully submitted,

PHILIP BURLING,
THEODORE P. SETO,
FOLEY, HOAG & ELIOT,
10 Post Office Square,
Boston, Massachusetts 02109.
(617) 482-1390